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FROM: Ernest G. Johnson
Director
Utilities Division

Date: October 25, 2007

RE: STAFF REPORT REGARDING ARIZONA PUBLIC SERVICE COMPANY'S
FUEL AUDIT IMPLEMENTATION PLAN (DOCKET NOS. E-01345A-05-0816,
E-01345A-05-0826 AND E-01345A-05-0827)

Attached is the Staff Report regarding Arizona Public Service Company's Fuel Audit Implementation Plan. Staff provides the attached report as required by Decision No. 69663.

EGJ:BEK:lmh

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Arizona Corporation Commission

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OCT 25 2007

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**Staff Report on
APS Fuel Implementation Plan**

**Docket Nos. E-01345A-05-0816,
E-01345A-05-0826 and E-01345A-05-0827**

**Presented by:
*Arizona Corporation Commission
Utilities Division***



October 25, 2007

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I. Purpose of This Report

Commission Decision No. 69663 in Docket No. E-01345A-05-0816 et al. required APS to file within 60 days an implementation plan for each Liberty audit recommendation it accepted and a detailed explanation supporting each recommendation it did not accept. Upon review of that report, Staff was to identify the best method for monitoring the Company's implementation plan and for resolving any issues in dispute. APS filed its "Fuel Audit Implementation Report" on August 27, 2007, and Staff has reviewed it. This report complies with the mission given to Staff by that Order.

Decision No. 69663 stated:

APS is in general agreement with the findings of the Liberty audit, and testified that some of the changes recommended by the audit have already been undertaken. Staff believes that a reasonable way to address audit findings is for the Company to prepare an implementation plan for each recommendation that it accepts, and for each recommendation it does not accept, APS should be required to provide a detailed explanation of the reasons why the recommendation need not be implemented. Staff would then identify the best method for monitoring the Company's implementation plan and for resolving any issues in dispute.

We agree with Staff's recommendation and will order APS to prepare and file an implementation plan and explanation within sixty days of the date of this Decision.

II. Summary of Staff's Recommendations

As the Order noted, APS was in general agreement with the findings of the Liberty audit, and had already undertaken some actions to implement the audit's recommendations. The APS Fuel Audit Implementation Report exhibited agreement with all Liberty audit recommendations (some not entirely but at least in major part). The report demonstrates to Staff's satisfaction that most of the recommendations have already been implemented, and require no additional monitoring.

In some cases, APS remains in the process of implementation, or has cited documents whose contents are important to determining whether completed implementation efforts completely address Liberty's recommendations. Staff is satisfied with the progress made to date in those two cases, but remains interested either in continued monitoring of remaining implementation activities, or in review of documents in a limited number of cases. Pending that monitoring and review, Staff recommends deferring consideration of the question of dispute resolution. After Staff completes those activities, there may be no disagreements.

In a few other cases, Staff believes that certain additional implementation activities are required. Pending APS review and response to recommended additional activities, Staff also recommends deferring consideration of the question of dispute resolution.

The following sections specifically address the APS response to Liberty's recommendations. It identifies those that Staff recommends be considered:

- Complete and requiring no further monitoring or dispute resolution
- Pending completion, after which APS will file a final completion report that Staff will review for consideration of any needed monitoring or dispute resolution
- Complete, subject to verification through examination of identified documents prepared by APS but not provided in its Fuel Audit Implementation Report (but not provided with that report)
- Subject to additional, herein-specified implementation activities, to which APS should respond before Staff addresses continuing monitoring or dispute resolution needs.

III. Chapter II – Organization, Staffing and Controls

A. Recommendation #1

Develop a complete set of procedures related to the management and administration of coal contracts.

1. APS Action

APS has accepted the recommendation, and implementation is in progress. The Company states that it is currently preparing specific desk instructions and detailed process flowcharts that describe Cholla, Four Corners, and Navajo coal and coal transportation contract management, procurement and administration processes. The Company expects these procedures to be prepared by mid-October 2007.

2. Staff Observations

Staff believes that the action described by APS is appropriate in meeting the intent of the recommendation. Final verification of successful implementation must await completion of the procedures. The schedule for completing them is appropriate, given the scope of the changes required.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

B. Recommendation #2

Audit and revise procedures for acceptance of offers for gas supply.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. The Company states that it has expanded its review process to compare its transacted physical gas prices to market prices through the use of prices captured each hour by an electronic trading platform. Traders transacting business outside of specified bounds are subject to trading violations, as described in the Company's Energy Risk Management Guidelines. In addition, the Compliance Manager has systematically undertaken a weekly audit process of all physical gas transactions.

2. Staff Observations

Staff believes that the action described by APS is generally appropriate. It does not, however, address the potential for conduct that can remain deliberately within the established bounds, while still proving disadvantageous to the utility.

3. Staff Recommendations

Incorporate a provision that would call for periodic reviews of in-bounds transactions to verify that their departure from an identified benchmark (e.g., median prices) is random, and not

preponderantly in a direction that would suggest lost value to the utility. These periodic reviews need not be as frequent as the weekly baseline reviews planned by APS.

C. Recommendation #3

Secure an understanding with APS that Commission auditing includes access to members of the Board of Directors.

1. APS Action

APS has accepted the recommendation, and has proposed a method for implementing it. That method will provide access to Board members when the Company determines that there are not other sources for securing the information in question. Where the Company determines otherwise, it proposes the use of discovery dispute resolution procedures to determine whether Board member access is required. The Company has suggested a process for implementation of this recommendation. APS suggests that the process reflects a good faith effort to comply with the recommendation and obtain the necessary information sought from members of the Board of Directors.

2. Staff Observations

Staff believes that the action described by APS is not consistent with Decision No. 69663. When access to Board members is desirable, then the use of discovery dispute processes would impose needless delay and resource use.

3. Staff Recommendations

Clarify that APS shall permit access to its Board of Directors in any future audit or prudence review conducted by Staff, as appropriate.

IV. Chapter III – Fuel Management

A. Recommendation #1

Streamline the procedures for handling of information on coal weights.

1. APS Action

APS has accepted the recommendation, and implementation is in progress. The Company has determined that electronic transfer of data will add benefit and efficiency at the Cholla Station for coal received from the Lee Ranch/El Segundo mine complex; a management summary report will be issued during the first quarter of 2008 to document these changes.

The Company has reviewed its processes at Four Corners Station and did not find a cost benefit associated with changing the existing process.

2. Staff Observations

The Company's implementation plans seem reasonable, provided that they are adequately supported by a number of documents discussed in the status report, but not provided by APS.

3. Staff Recommendations

APS should provide the management summary report documenting the changes made at the Cholla Station. Further, APS should provide the cost/benefit analysis conducted on the existing process at Four Corners that resulted in the determination that changes in processes at this station were not necessary.

B. Recommendation #2

Revise the inventory target for Regular Coal at the Cholla Station from 25 days of supply to 35 days of supply.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. APS has issued the appropriate inventory target letter for 2007, complying with this recommendation. APS describes the process of establishing inventory targets, which it bases on evaluations of contractual commitments for coal supply and rail capacity, as well as projected burns. Analysis of this information will be conducted annually in order to confirm inventory targets for the subsequent year.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

C. Recommendation #3

Conduct a comprehensive analysis of gas purchasing and management under ELP's revised rate structure, and report to the Commission.

1. APS Action

APS has accepted the recommendation, and implementation is in progress. Currently, the ELP rate case before FERC is pending settlement, and an order is expected during the fourth quarter of 2007. After the price structure and fees for future gas transportation costs are final, the Company will conduct a comprehensive analysis on the impact of these costs on both the Company and its customers. In the interim, initial reviews of various price and fee scenarios, along with detailed analysis of natural gas pipeline costs and options for minimization of these costs, are in progress. The Company expects to complete and file the recommended report by the third quarter of 2008.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

The Company should file the expected report detailing its analysis of natural gas purchasing and management under ELP's revised rate structure.

V. Chapter IV – Fuel Contracts

There were no recommendations in this area of examination.

VI. Chapter V – Hedging and Risk Management

A. Recommendation #1

Engage stakeholders in a discussion of hedging program objectives.

1. APS Action

APS has accepted the recommendation, and implementation is in progress. The Company plans to meet with customer group representatives in the upcoming months to obtain input regarding the hedging program and customer preferences. The Company intends to report to Commission Staff on these meetings.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

The Company should provide Commission Staff with the expected referenced report on meetings with customer group representatives, and should, after consultation with Staff, identify proposed means for addressing issues or concerns raised by those meetings.

B. Recommendation #2

Report to the Commission on the future plans for non-utility trading activities.

1. APS Action

APS has accepted the recommendation, and implementation is in progress. The Company continues to work towards the elimination of remaining non-utility activities with the expiration of the last non-Company full requirements contracts in mid-2008. In 2007, Pinnacle West Marketing and Trading sold a number of its non-utility gas and power commodity positions to Morgan Stanley, subject to approval of that transaction by FERC. On August 16, 2007, FERC approved the transaction, and the Company hopes to have the transfer of those positions to Morgan Stanley completed by the fourth quarter of 2007. In addition, the Company has accomplished the physical separation of the Company's utility and non-utility traders as of October 2006.

2. Staff Observations

Staff believes that the action described by APS is appropriate, given the continuation of efforts to close-out non-utility activities.

3. Staff Recommendations

The Company should report to Commission Staff when the above described transfer of positions to Morgan Stanley has been completed. The Company should also report quarterly on continued close-out actions, schedule for completing the remainder of those actions, and any changes to its plan or schedule for final close-out.

VII. Chapter VI – Forecasting and Modeling

There were no recommendations in this area of examination.

VIII. Chapter VII – Plant Operations

A. Recommendation #1

Prepare and execute an action plan that will improve economic evaluations related to minimization of outage time.

1. APS Action

APS has accepted the recommendation, and states that implementation is complete. APS has implemented Managerial Policy A-13 Evaluation of Unit Outages/Unit Reductions and dated 8/06/07, which formalized evaluation of costs during these types of outages. APS states that they have also evaluated all systems at their base and immediate load stations in this regard and in accordance with Managerial Policy A-6 Inventory Management, dated 10/01/03.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

B. Recommendation #2

Analyze system reserve requirements using both a 50/50 and 90/10 load forecast, incorporating the constraints of the Phoenix Load Pocket.

1. APS Action

APS develops a 90/10 load forecast and provides it to System Planning where it is used in discussions of system reserves and the Phoenix Load Pocket. APS states that the Company will seek ways to incorporate the 90/10 forecast more formally.

2. Staff Observations

Staff believes that the action described by APS is a constructive start, but does not yet incorporate the more formal approach recommended. The balance of load and generation for an important metropolitan area such as Phoenix coupled with constraints into the area, high load growth across the entire system, and low overall reserves requires formal analysis.

3. Staff Recommendations

Staff recommends that APS conduct reserve level analyses with both 50/50 and 90/10 load forecasts, incorporate the constraints of the Phoenix Load Pocket into those analyses via a two area calculation, and provide to Commission Staff an analysis demonstrating that the ultimate approach and load forecast used by APS for determination of its overall reserve level and transmission capability into the Phoenix Load Pocket is adequate.

C. Recommendation #3

Evaluate the replacement of boiler sections at Four Corners #5, Navajo #2, and Navajo #3 in light of current high net replacement power costs.

1. APS Action

APS states that a boiler tube failure reduction program is in effect at each planned outage, and that boiler component replacement has always been based on replacement fuel cost. APS offers Managerial Policy O-11 Integrated Boiler Tube Failure Reduction/Cycle Chemistry Improvement (BTFR/CCI) Program for Coal Units and HRSGs, and dated 3/27/00 – Revised 02/15/07.

2. Staff Observations

Staff has a concern about the effectiveness of the program described. The boiler-tube-failure program presented by APS has been in place for a long time, and it is representative of industry practice. It should by now have demonstrated some success in reaching the goal of reducing boiler-tube failure. The numbers presented do not evidence success. Staff does not have the 3/27/00 version of Managerial Policy O-11. If that version of the policy has the same goals for the 6-year forced outage rates set to be achieved in the next four years as the 02/15/07 version, then Staff believes that the APS action is incomplete. If the 02/15/07 version of Managerial Policy O-11 has set new and lower goals for 6-year average forced outage rates, Staff believes that evaluation of whole boiler components will be required to reach those goals, which would make APS implementation of the recommendation complete.

3. Staff Recommendations

Staff recommends that APS submit to Commission Staff its plans to reach the 6-year average forced outage rates stated in Management Policy O-11, detailing what will be required for boiler component replacements, other improvements, and the anticipated benefits of each for each of its generating units listed.

D. Recommendation #4

Conduct a centralized review of operator and maintenance errors at APS base-loaded coal plants and at Navajo, in order to assure that root causes are being correctly identified and addressed; determine the reasons why such errors appear to be concentrated at Four Corners Unit #3 and Navajo Unit #3.

1. APS Action

APS does not agree that there is an unusual pattern of operator error at Four Corners 3 or Navajo 3, but does not object to a centralized review of existing policies and procedures providing updates as required. APS offers Managerial Policy A-3 Incident Reports, dated 01/29/81 (revised 02/24/00), which requires a root cause determination determined after plant trips and operator errors. APS also offers Managerial Policy A-9 Lost Generation Analysis and Report, dated 06/15/98 (revised 5/03/07), which requires an annual report on lost generation on each unit. In addition, APS offers Managerial Policy O-16 Root Cause Evaluation, dated 05/07/01 (revised

07/08/02), which requires a formal or informal root cause evaluation to investigate personnel accidents, equipment damage, or other undesirable events.

2. Staff Observations

Staff considers the policies and procedures addressing APS review of existing root causes to be satisfactory, but the recommendation went more to the implementation than the content of those policies and procedures. An example will help explain. Lightning may be identified and listed as the root cause of a transformer failure. That may well have been the immediate cause, but other factors, such as contamination during manufacture, improper assembly instructions to the assembler, inadequate or improper lightning protection determination or installation, among others may have exposed the transformer to failure from the immediate cause of lightning. Identification of lightning as *the* root cause would not be helpful in such a case.

3. Staff Recommendations

The recommendation would be better met by commissioning an expert and independent review of a sufficient number of APS root cause investigations and analyses (involving generating stations) to verify that the conduct of the analyses has been sound and effective, and, if not, to recommend any appropriate improvements.

E. Recommendation #5

Implement for West Phoenix #5 the requirement for root cause analysis when generation is lost.

1. APS Action

APS states that at the time of the report, West Phoenix 5 was required to comply with all root cause requirements as other fossil plants.

2. Staff Observations

Liberty understood the case to be different during its audit, but considers the response adequate to the extent it represents that West Phoenix 5 was and, more importantly, remains covered by the requirement.

3. Staff Recommendations

Staff has no further recommendations in this regard except those that are discussed under Recommendation #4 above.

IX. Chapter VIII – Purchased Power and Off-System Sales

A. Recommendation #1

Clearly segregate utility and non-utility trading in all operations and reporting to ensure that utility trading is conducted to maximize utility opportunities.

1. APS Action

APS has accepted this recommendation in part, and states that its action on this item is complete. The Company states that it has addressed the separation and reporting issues in its report related to Recommendation #2 in the Hedging and Risk Management chapter. With regard to FERC reporting, the Company states that it follows all applicable reporting requirements for each of the varied FERC forms that it files, and that the FERC does not recognize, for reporting purposes, a distinction between utility and non-utility activities.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

B. Recommendation #2

Complete the process of preventing future affiliate use of utility assets and examine means for continuing transmission optimization transactions through some form of sharing mechanism.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. The Company states that its Code of Conduct Policy #11, Provision of Trading Floor Services by APS addresses the improper use of utility resources by affiliates. Also, as mentioned earlier, the Company is moving to eliminate its non-utility activities. The Company also states that it continually pursues market opportunities to optimize transmission pathways by making purchase or off-system sales transactions that appropriately utilize existing purchased transmission capacity.

2. Staff Observations

The Company response did not address the findings of efforts to determine whether the specific opportunity that gave rise to the concern underlying the recommendation can be exploited through means that appropriately manage utility risk/reward considerations.

3. Staff Recommendations

APS should report on the results of its efforts to seek a means for capturing the benefits of the specific opportunity in question in a means that adequately mitigates utility risk, if that opportunity is still present.

X. Chapter IX – Nuclear Fuel

There were no recommendations in this area of examination.

XI. Chapter X – Financial Audit of PSA Costs

A. Recommendation #1

Conduct periodic internal audits of the PSA filings to verify the soundness, completeness, and accuracy of the activities that produce them, with the first such audit to be conducted as part of the next audit plan.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. The Company states that the Pinnacle West Internal Audit Department incorporated a PSA Filings Audit in the 2007 Audit Plan. The first audit was completed in July of 2007. The objective of this audit is to gain an understanding of the preparation of monthly PSA filings and to verify the integrity and reliability of the information. The PSA Filings Audit is a recurring audit that will be conducted periodically.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

B. Recommendation #2

Develop a written policy and procedure for the preparation of the confidential PSA filings.

1. APS Action

APS has accepted this recommendation in part, and states that its action on this item is in progress. The Company states that it is in the process of revising its documentation supporting the monthly PSA filings to include new procedures required by the adoption of a prospective PSA Decision No. 69663. The updated procedure is expected to be available by the fourth quarter of 2007.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

C. Recommendation #3

Correct PSA reporting methods to assure more accurate classification and reporting of coal, oil, and gas generation information.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. The Company reports that it has revised the supporting schedule information in the confidential portion of the PSA filing to reflect the above recommended method of reporting fuel cost.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

D. Recommendation #4

Revise the PSA confidential filing format to provide a sufficient level of detail to support the calculation of the components contained within PSA non-confidential filings.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. The Company states that it has revised current schedules and prepared new schedules for inclusion in the confidential portion of the monthly PSA filing that provide the additional support necessary to review the non-confidential PSA monthly filing. These schedules were initially provided in the August 2006 PSA report and have been included since that time.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.

E. Recommendation #5

Closely review and monitor adjustments to fuel costs to assure that supplemental charges and refunds appropriately consider the impact on inventory values and fuel expenses for financial reporting purposes.

1. APS Action

APS has accepted the recommendation, and has completed implementation of this recommendation. The Company reports that its accounting personnel have been trained to understand and implement the proper accounting method(s) for booking supplemental charges, refunds, and other adjustments to fuel expense and/or inventory values.

2. Staff Observations

Staff believes that the action described by APS is appropriate.

3. Staff Recommendations

Staff has no further suggested actions related to this recommendation.